BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF DELAWARE

IN THE MATTER OF THE INVESTIGATION OF THE PUBLIC SERVICE COMMISSION INTO REVENUE DECOUPLING MECHANISMS FOR POTENTIAL ADOPTION AND IMPLEMENTATION BY ELECTRIC AND NATURAL GAS UTILITIES SUBJECT TO THE JURISDICTION OF THE PUBLIC SERVICE COMMISSION (OPENED MARCH 20, 2007)	))))))))	PSC REGULATION DOCKET NO. 59

REGULATION DOCKET NO. 59 FINAL COMMENTS
APRIL 1, 2008

Chesapeake Utilities Corporation ("Chesapeake", or "the Company") offers the following comments and observations in response to the March 17, 2008 working group:

I. General Overview:

The fundamental principle behind the implementation of a revenue decoupling mechanism is to more closely match the recovery of a utility's fixed costs with fixed revenue. The vast majority of Chesapeake's (and any Utility's) operating costs are fixed. Under the company's current rate design most fixed costs are recovered from variable rate revenues. The recovery through delivery base rates of the Commission approved revenue requirement assumes a forecast of consumer usage that may vary significantly from actual usage based on weather, economic conditions, consumer conservation or other factors. Chesapeake has little or no control over consumer gas usage. To the extent consumption varies from forecast levels the Company will over or under-recover its revenue requirement. Implementation of revenue decoupling would break the direct link tying revenue to consumption. A decoupling mechanism would impose no additional costs on consumers beyond those approved by the Commission in a base rate proceeding. A decoupling mechanism will not provide Chesapeake with a guarantee

that Chesapeake will earn the authorized rate of return. Because the Company is not protected from increased costs it is incented to manage costs and operate efficiently.

Beyond the issue of aligning fixed cost and fixed revenue is the fundamental concern of many states, including Delaware, to take action in promoting energy conservation (the Sustainable Energy Utility (SEU) legislation is one example). The heightened interest in greenhouse gas carbon emissions has played a major role in the call for reduced energy use. In Delaware, the Delaware Climate Change Consortium began a process in 2000 that quantified the opportunities for energy efficiency and carbon reduction that lead to the authorization of the SEU. While much of this attention has been focused on electric generators, gas utilities have also been encouraged to implement conservation programs. Chesapeake recognizes the need to support efforts to reduce consumer gas costs. In the long run, utilities that resist or work in opposition to the best interests of their consumers will not succeed. Moreover, while it is anticipated that SEU will be aggressive in promoting energy conservation, it would be extremely short-sighted to assume that SEU can make significant progress without the assistance of the utilities in Delaware.

Clearly, over the past several years the increase and volatility in gas commodity prices has raised the interest in energy conservation among consumers, efficiency advocates, utilities and government entities. Forecasting consumer usage patterns which account for price elasticity effects and the general improvement in appliance and housing energy efficiency has become problematic, especially during proceedings to set base rates. The use of a weather normalization adjustment in a base rate case in an effort to determine test period revenues based on “normal” weather is becoming increasingly difficult. The end result is an assumed revenue amount that is nothing more than an educated guess. The U.S. gas distribution industry has tracked a steady decline in gas use per customer dating from the early 1970’s. According to an American Gas

Association (AGA) study, today's average American home uses 25% less natural gas than in 1980. The Company's experience in its Delaware system is similar to the national trend. The Company is recording steady declines in usage per consumer, especially among residential consumers. Despite this reduction in usage per consumer, utilities are being asked to do more in an effort to achieve further reductions. Decoupling would eliminate a utility's reluctance to encourage conservation and enable Chesapeake to promote consumer energy efficiency and conservation. Decoupling would however only affect the delivery service charge portion of the bill (approximately 39% of a residential bill). Because the gas cost component of the bill continues to be billed volumetrically, consumers would have an incentive to conserve.

Chesapeake has two fundamental concerns related to the emerging conservation policies in Delaware. First, as each of the initial responses acknowledge, most existing regulated utility rate designs are based on traditional rate setting practices that recover only a portion of a utility's fixed costs through customer or demand charges. The majority of fixed costs are recovered through variable charges based on volumetric consumption. This rate design generally rewards utilities for increased sales between rate cases. If aggressive conservation programs are implemented (by Chesapeake, the SEU, or other entities in the marketplace) gas consumption per customer will likely continue to decline and Chesapeake's revenue recovery will be affected. Second, extending natural gas service to new un-served areas is important to Delaware's overall energy program. Carbon emissions from natural gas appliances are significantly less than emissions from virtually any other fuel source, when energy production source emissions are considered. The Commission should adopt policies, rate designs or regulatory strategies that encourage the prudent expansion of gas distribution systems to serve new customers.

II. Revenue Normalization Mechanism:

The principle decoupling mechanism proposed by Chesapeake is the Revenue Normalization Mechanism (RNM). Chesapeake continues to believe the RNM provides the best alignment of Company and consumer interests. It is based on Chesapeake's approved Maryland RNM model, which allows a 10.75% return on equity ("ROE"). RNM provides annual delivery service margins by rate schedule, which are set in the base rate case. On a monthly basis revenue requirements are calculated by rate schedule and any over/under recovery of the approved revenue is accrued. This over/under recovery would be included on the customer bills each quarter. RNM is consistent with the regulatory rate tracker mechanism philosophy in that it takes into account the fact that gas sales are outside the control or influence of the utility, actual sales volumes are likely to deviate from the baseline projections used in the rate case to set rates, and even small variations in sales can have material impacts on earnings.

III. Reasons For Staff Opposition to Chesapeake's Proposal:

The Commission Staff expressed concern that the Company would have "less incentive to increase efficiency in order to maintain its margin in the face of revenue erosion; while the ability to realize the upside potential of greater cost efficiency is not eliminated by decoupling." Staff stated this would "send the wrong price signals and could push rates higher in economic downturns", and thereby "exacerbate the impact on ratepayers." Additionally, Staff stated it would be "difficult to isolate the effect of efficiency-driven revenue erosion". Finally, Staff expressed concern that only a minority of ratepayers would benefit directly from utility-based conservation efforts because of market barriers.

IV. Commission Staff's Proposal:

It is the Staff's position that "revenue decoupling should proceed for each utility in a separate base rate case proceeding where Staff will support a modified fixed/variable rate design

approach to revenue decoupling". Staff states that "Bill Stabilization Adjustments or Revenue Decoupling surcharges are unacceptable". Instead, "Staff supports collecting fixed costs through customer or demand charges as part of a base rate proceeding (assuming no inequitable customer or class impacts)". Staff further states that "consideration must be given to rate gradualism, customer equity, and customer service and reliability protections". According to Staff, with reduced regulatory proceedings, the utility's' rate design should reflect a change to its risk profile, presumably with a reduction in the ROE. Staff also suggests that there would be a need for some form of over/under earnings protection.

V. Chesapeake's Response to Staff's Recommendations:

The Staff has indicated an interest in adopting a Straight Fixed Variable (SFV) rate design instead of an RNM. Chesapeake is generally supportive of a move to SFV. SFV rates offer simplicity in implementation for the utility while being easily understood by the customer. SFV rates would help stabilize bills by limiting seasonal volatility and eliminating the need to true-up, or change prices between rate cases. A properly structured SFV rate design would help mitigate intra-class subsidies favoring low use consumers and promote utility support of consumer conservation. SFV also sends a more appropriate price signal to consumers.

A fundamental concern with any SFV rate design is that it be structured properly. For example, a rate design that retains multiple rate blocks, increases the customer charge, and lowers the volumetric rate on the first block (which is primarily considered fixed revenue) will not accomplish the goals of revenue decoupling. The utility's revenue will still be significantly tied to volumetric consumption. Chesapeake's proposed rate design in its current base rate proceeding would eliminate the existing volumetric rate blocks in favor of a higher monthly customer charge. The proposed customer charge for each residential rate class would generally recover revenue in an amount equal to the existing customer charge plus the first rate block.

Chesapeake finds that SFV rates tend to increase rates for smaller volume users within a class and additional class stratification may be required to set reasonable rates and gain public acceptance.

From Chesapeake's perspective there is still the issue of identifying fixed costs. The vast majority of any utility's (Chesapeake included) operating costs are fixed. According to Ken Costello, Senior Institute Economist for the National Regulatory Research Institute, "for many gas utilities, over 90% of their non-gas costs reflect fixed costs, with the majority of those costs typically recovered in the volumetric charge…. Problems arising from this allocation include under-recovery (or over-recovery) of a utility's prudent fixed costs and disincentives for a utility to promote energy efficiency."

While Chesapeake understands the Staff's concept of "rate gradualism", spreading the move to SFV over multiple rate cases would be counter-productive. For example, in Chesapeake's pending rate case, the Staff has suggested that the move to complete SFV should take place over the Company's next two to three base rate cases. This could take approximately fifteen years to accomplish.

Regarding the need for "over/under-earnings protections" Chesapeake believes this is already addressed in 26 Delaware Code Section 310 which authorizes the Commission to reduce the rates of any utility that is over-earning. Utilities are already required to file quarterly reports with the Staff so that the Staff can monitor the utility's earnings. If the utility appears to be over earning, Section 310 gives the Commission the authority to initiate proceedings to reduce rates.

Chesapeake does not believe any adjustment to the rate of return is necessary. While a SFV rate design stabilizes revenue to a certain extent, it does nothing to impact the level of costs incurred by the Company. Chesapeake does not believe the implementation of a SFV rate design will have any adverse impact on customer service, or reliability. The Company will still need to

keep its current customers and add new customers in order to grow its business. No company can succeed if it ignores customer service.

VI. The Path Forward.

Chesapeake is in the process of finalizing its pending base rate case in PSC Docket 07-186. In its rate case, Chesapeake seeks approval to implement a form of revenue decoupling. Like Delmarva Power, Chesapeake sought approval to implement revenue decoupling in the context of a rate case. In Delmarva's base rate case, the Commission concluded that the issue should first be addressed in a separate regulation docket. This policy decision resulted in the commencement of Regulation Docket No. 59. However, Regulation Docket No. 59 has not been concluded at this point, and it appears unlikely that Regulation Docket No. 59 will be concluded prior to the conclusion of Chesapeake's rate case. Once the Commission adopts a final position in Regulation Docket No. 59, the Commission should allow Chesapeake the opportunity to initiate, on a revenue neutral basis, a rate design proceeding so that Chesapeake can implement any appropriate rate design sanctioned by Regulation Docket No. 59. Chesapeake should not be required to wait until its next base rate proceeding to implement any regulatory changes authorized by Regulation Docket No. 59.

Respectfully submitted,

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